

APPENDIX

Notes for FOMC Meeting
held on March 31, 1987

Sam Y. Cross

Soon after your last meeting, officials of six major industrial countries met in Paris, and as a result of their discussions, market participants became more confident that the U.S. was willing to cooperate with other countries to stabilize exchange rates. Although in early March the dollar began to edge down, the foreign market remained relatively calm at that time. But, by the third week in March, market participants, rightly or wrongly, began to believe that the Administration was again welcoming a depreciation of the dollar, and U.S. officials were again commenting on Japanese trade practices. As a result, the relative calm that had settled on the foreign exchange markets was shattered last week as the yen started to lead in the advance of currencies against the dollar. On balance, the monetary authorities of the Group of Five have been able to hold the dollar's decline against the yen to about 5 percent during the intermeeting period, but only at the cost of substantial dollar purchases totaling more than \$10 billion by both U.S. and foreign authorities. Moreover, by yesterday morning, the impact of a weak dollar could be seen in all of our domestic financial markets.

The February 22 agreement to foster stability in the exchange rates among the major industrial countries was reassuring to the market. The official statement released after the Paris meeting stated that these currencies were now "within

ranges largely consistent with underlying fundamentals," and that "further substantial exchange rate shifts among their currencies could damage growth and investment prospects in their countries." The officials agreed "to cooperate closely to foster stability of exchange rates around the current levels" and announced policy commitments to reduce their external imbalances. The official statement following the meeting was also widely interpreted as indicating that the monetary authorities were prepared to intervene to provide firm support for dollar exchange rates. As a result, through early March, dollar exchange rates, especially against the yen and the Deutsche mark, traded within a relatively narrow range.

This period of relative calm in the exchange markets did not last. The dollar first rose out of the narrow trading range, advancing against the mark. In response to an increasingly clouded outlook for the German economy, market participants chose to cover some of their short dollar positions against the mark. On March 11, as the dollar moved up through the DM 1.8700 level, the Desk sold \$30 million against marks in accordance with the agreements reached in Paris. This operation, though limited in size, was visible and taken by market operators as a signal that the Paris agreement would seek to limit any significant rise of the dollar, as well as any significant decline. As a result, the dollar's recovery was, in a sense, capped and the dollar subsequently began to move lower.

As the dollar declined, most market participants chose

to focus on the Japanese yen. The yen was about as weak as it has been against the European currencies since the 1985 Plaza Agreement. Also, extensive press coverage of trade disputes with Japan, together with intensifying domestic political pressures against Mr. Nakasone on budget and tax policies, left the impression in the markets that the G-6 strategy for dealing with external imbalances was not working. As the dollar eased back down through several psychologically important levels, Japanese participants looked for signs of intervention, particularly when the dollar moved through the Y152 level on March 16, and then decisively below the Y150 level in Tokyo on March 24. But, instead, statements by U.S. Treasury officials sounding neutral about the exchange rate were interpreted as indicating lack of commitment to exchange rate stability. Thus, sentiment towards the dollar became more bearish and the selling of dollars became widespread. There were signs that the markets were becoming increasingly one way. By last Friday, in a spot turnover of \$6 billion in Tokyo, the Bank of Japan purchased

As you know, intervention during the last week has been heavy and has been done as a cooperative effort among the Group of Five. To date, the net dollar purchases against the yen undertaken in keeping with the understandings reached in Paris have amounted to more than \$10 billion. Of this sum, \$2,116.2 million was done by the United States monetary authorities beginning on Tuesday, March 23. The FOMC subcommittee on Foreign Exchange conferred on several occasions to allow the Desk to

exceed the daily limit on operations in yen and on one occasion to raise the intermeeting limit on change in open position to \$1 billion from \$600 million.

In other developments, on February 13 the Bank of Mexico completely repaid outstanding drawings on its credit facilities with the U.S. monetary authorities, paying \$61.4 million to the Federal Reserve and \$61.6 million to the U.S. Treasury.

Right now the psychology is heavily against the dollar. Since Paris, there have been no policy moves by any of the participants toward reducing the external imbalances and no statistical evidence that the imbalances--at least in nominal terms--are declining. Additional negative factors are the disputes over trade issues and macro conditions, which lead to some expectation of further dollar depreciation as a trade move; political problems in Japan, which lead to doubts about the government's ability to deal effectively with the imbalance; and a less-than-full conviction of the market of the firmness of the U.S. commitment to greater exchange rate stability.

**NOTES FOR FOMC MEETING
MARCH 31, 1987
P. D. STERNLIGHT**

The Domestic Trading Desk has continued to aim for essentially unchanged conditions of reserve availability in the period since the last meeting, although in the past few days we have moved in a relatively cautious manner to meet large projected reserve needs in view of the weakness of the dollar in the foreign exchange market. Throughout the period, reserve paths were drawn based on a \$300 million level for adjustment and seasonal borrowing that was generally expected to be accompanied by Federal funds trading in the neighborhood of 6 percent or a shade higher. Other factors in the background included a continuing mixed bag of economic data that on balance suggested moderate overall real growth, also mixed reports on prices with occasional reminders of the potential for quickening increases including the sag in the dollar late in the period, and notably slow growth in monetary aggregates. While the M2 and M3 measures, averaging around 1 or 2 percent annual growth rates in February and March, tracked well below the Committee's 6-7 percent short-term guideline, there seemed little reason to consider a more accommodative Desk posture. Rather the slowing appeared to reflect some unwinding of the growth bulge late last year and over year-end, possibly accompanied by a longer-term move toward a more moderate growth pace. As such, the slowing seemed quite welcome. M1 also paused from its earlier hectic pace, rising only at about a 2 to 2-1/2 percent pace over

February and March.

Federal funds traded largely in a fairly narrow range centered on 6 to 6-1/8 percent, with two-week averages sitting in a close 6.08 - 6.11 percent band. Early in the period, there was some trading around 6-1/4 or higher, particularly around the mid-February settlement date for Treasury financing. There was also some concern around that time that the Fed might be encouraging, or at least readily accepting, a bit greater firmness in day-to-day conditions of reserve availability. Comments at the Humphrey-Hawkins hearings, noting an absence of recent official changes in stance, helped set these concerns aside. Some moderate pressure emerged again at the mid-March tax date, but it soon subsided. Some pressure has also emerged in the last day or two--apparently related to the quarter-end and perhaps to our cautious pace in meeting the current period's reserve need--but these pressures are far less than we saw in late December. For one thing, there has been nothing like the huge credit expansion that marked the December period and underlay the sharp rise in pressures. Moreover, the particular situation which had been a factor in December and was of some concern

Discount window borrowing averaged a close-to-path \$280 million for the three full reserve periods since the last meeting, with individual reserve periods in a range of about \$190

to \$380 million. The seasonal component of borrowing has edged up a bit over the course of the period, implying a touch less pressure now than a month or two ago in association with a given level of path borrowing. Nonborrowed reserves also turned out fairly close to path levels over the period, as did excess reserves.

Desk outright activity has been moderate over the period. Initially, with some need to absorb reserves in response to a declining Treasury balance, the System sold a little over \$500 million of bills to foreign accounts. Subsequently, and through virtually the whole period, the Desk bought bills from foreign accounts in a total amount of about \$1.2 billion. Reserves were supplied many times on short-term through repurchase agreements, chiefly the pass-through of customer orders that would otherwise absorb reserves. On one occasion, the Desk absorbed reserves through matched-sale purchase transactions in the market. In the current and upcoming reserve periods, however, we face quite large reserve needs, reflecting normal seasonal expansion of required reserves and currency outflows, somewhat augmented by the reserve draining impact of foreign exchange intervention.

Interest rate developments during much of the period were notable for their lack of movement, amidst markets that were so lethargic that dealers worried about being able to meet overhead costs. In the last few days, however, activity picked up and there was a pronounced rise in rates--mainly reflecting

concerns about the weakening dollar and related anticipation that foreign buying of securities would let up or even reverse. Early in the period there was some relief, following the Humphrey-Hawkins testimony, that monetary policy was holding unchanged where some had sensed a slight firming. Business news, alternately blowing hot and cold on the economy, elicited only small reactions in the market; there was some tendency to see current growth as a bit stronger but chiefly attributable to inventory accumulation and hence of questionable durability. Little attention was paid to the slowing of money aggregates, particularly as many analysts saw this as an unwinding of earlier excesses rather than a sign of weakness to come. A little comfort was taken from the sense that Treasury cash needs are abating but this, too, was tinged with skepticism as to its durability. A frequent comment among Treasury market participants was that attention was being diverted to other U.S. markets, such as those for mortgage-backed securities or equities, or to foreign markets--notably the U.K. gilt-edged market.

The Treasury paid down about \$16 billion of short-term bills during the period as they preferred to keep cash-raising cycles intact in the note and bond area while adjusting to temporary cash excesses through reductions in bills. Even so, shorter bill rates showed little net change over the interval, as financing costs worked to resist declines, and rates pushed higher against the background of dollar weakness in the last

couple of days. There were occasional flurries of interest in bills in the wake of news about LDC problems but these incipient "flights to quality" never really got off the ground. In yesterday's auction of three- and six-month bills, rates of 5.72 and 5.80 percent compared with 5.72 and 5.69 percent just before the last meeting.

For most Treasury coupon issues, there was scarcely any net change in yield over most of the interval, but sharp price declines on the last couple of days lifted yields for the full period by some 15-30 basis points. The Treasury raised about \$20 billion through coupon issues over the interval--over half of it through the sales of two, four and seven-year issues conducted last week. Treasury market advisers are meeting currently to discuss ideas about modifying the current pattern of coupon issuance, particularly in light of the potential for smaller deficit figures.

Until time of the dollar-related rate increases of the last few days, sentiment in the Treasury market seemed to call for no near-term change in rates. The vulnerable dollar has been seen as ruling out an easing while modest growth in the economy counsels against firming--though the weak dollar is seen as a factor that could influence day-to-day implementation of policy in a less accommodative direction. Looking further out, there's a division of views as to whether rates may tend higher or lower by the latter part of this year, with perhaps a majority, but a shrinking one, looking for lower rates.

On a housekeeping matter, I should mention that the Desk began trading last week with three of the five firms that were added to the primary dealer list last December. The three were

This was a normal follow-up to the continued satisfactory market-making performance of these firms since being added to the list. Action was deferred in respect to

reflecting less evidence of robust activity as well as management changes at those firms that made us want to watch developments somewhat longer.

Finally, as mentioned earlier, current projections point to large reserve needs in the upcoming intermeeting period. Quite possibly this will call for an increase in the usual \$6 billion intermeeting leeway. My preference would be to wait and get a better fix on the size of the need before making a specific request.

J. L. KICHLINE
MARCH 31, 1987

FOMC BRIEFING

The pace of economic activity appears to have picked up in the first quarter, following the sluggish growth of last quarter, while prices have risen faster as well. In the first quarter, final domestic demands apparently fell and inventories were rebuilt, the opposite of late last year when strong final demands--induced partly by tax reform--were accompanied by inventory drawdowns. In addition, we expect real net exports have contributed to expansion of real GNP as they did last quarter, although there is little hard information yet available on trade developments.

The staff's updated forecast incorporates some near-term changes, but in a fundamental sense is not different from that presented at the last meeting of the Committee. We have continued to assume a fiscal policy of restraint and a reasonably accommodative monetary policy. In that context, real GNP is projected to expand at a rate of 2-1/2 to 3 percent this year and next, with real net exports providing increased support while growth of domestic demand slows. The GNP deflator is projected to rise at a 3 to 3-1/2 percent pace over the next two years.

Some pieces of information on economic developments have provided signs of considerable strength early this year, and that is particularly the case for labor market indicators. Nonfarm

payroll employment adjusted for strikes grew at more than 300,000 per month during January and February, appreciably faster than in 1986, and the average workweek was lengthened. Gains in employment were matched by expansion of the labor force so that the unemployment rate has remained stable at 6.7 percent. To some extent, employment gains have been inflated by unusually mild winter weather during the survey weeks and by other seasonal adjustment difficulties, but even so labor inputs have been large. The staff expects employment growth to slow, consistent with the forecast of moderate economic expansion.

Industrial production early this year has continued the uptrend evident since last fall. In February, the production index rose one-half percent with gains broadly based; assuming only a small further rise in output for March, industrial production would be up at about a 4 percent annual rate in the first quarter. Some of the output is showing up in inventory accumulation, although stocks generally seem in good shape aside from domestically produced automobiles. Stocks of domestic autos grew substantially in the first quarter at a time of sluggish sales following the year-end surge. The recent round of sales incentive programs seems to have had only a limited effect on demand, and even with the pickup in sales in the staff forecast, production plans are expected to be trimmed further to help bring stocks down to more comfortable levels.

Consumer spending on goods other than autos and services appears to be growing at a moderate rate. Gains in disposable income have been boosted by the strength of employment and tax reduction, and wealth positions have been improved given the rise of stock prices this year; equity values, in fact, are still up roughly \$500 billion since year-end even with the poor market performance of the past couple of days. These factors should help support consumer spending, but with a relatively low saving rate and high debt burdens we do not expect consumers to be the driving force as they were over the past couple of years.

The housing market has been quite strong early this year, with starts in January and February averaging more than 1.8 million units at an annual rate--higher than we anticipated. It seems the added strength may reflect seasonal forces given that the bulk of the rise in starts relative to the fourth quarter was in the Midwest which had favorable weather; in that area of the country one actual start in January and February equates to 2-1/2 starts seasonally adjusted. In any event, we are forecasting some slackening in starts from the recent pace, but a still good rate supported by strength in the single-family sector.

Indicators of business fixed investment spending generally have been weak in recent months. Shipments of nondefense capital goods fell during January and February

combined, in part associated with the tax-related surge late last year. However, orders also moved lower and we've been inclined to reduce a little what was already a sluggish investment outlook for 1987.

On the whole, the information available on the economy has been subject to a number of diverse and, in certain instances, transitory influences. But as noted earlier, the economy in the aggregate seems to be moving along a path consistent with earlier expectations. The same holds for price developments, where energy prices contributed importantly to the acceleration of inflation early this year. The bulge in energy prices is expected to end in the next month or two given the assumed rough stability in world oil prices, but the impact of rising nonpetroleum import prices is expected to maintain somewhat greater inflationary pressures than last year. There, of course, has been a good deal of uncertainty surrounding the domestic price impact of the dollar depreciation, although given the current level of the foreign exchange value of the dollar further rapid depreciation would pose a clear upside risk to the staff's price forecast.

Donald L. Kohn
FOMC BRIEFING
March 31, 1987

The period since the last meeting has been marked by two main developments in financial markets--weak money growth and the downward movement of the dollar--that the Committee may want to pay particularly close attention to when considering its plans for the upcoming period. With regard to money, the broad aggregates were essentially flat in February and have expanded very slowly in March, and growth on M1 likewise has been subdued. Some of the deceleration was to be expected, as the effects of the year-end bulge in transactions and lending wore off. Even so, growth over the last two months has been substantially less than anticipated at the last meeting, leaving M2 below and M3 around the lower ends of their long-run ranges.

The sharp slowing in money growth does not seem to be signaling concurrent weakness in income, given employment and output data so far this year. Nor, judging from corollary market indicators, does it seem to suggest a tightening in monetary policy that portends future shortfalls in the economy. Until very recently when concerns about the dollar have come to dominate market psychology, nominal interest rates had been virtually flat over the intermeeting period; real rates, if changing at all, likely had been edging down given recent price data, and the stock market was soaring. The intense downward pressure on the dollar, of course, also would not suggest rising real rates or monetary stringency.

Rather, the weakness in money probably reflects in large measure changes in the public's asset and liability preferences, with little implication for the economic outlook. Some of the slowing of money growth represents the expected moderation of shifts into money balances that had been

prompted by the steep declines of market interest rates through last summer. But beyond that, with offering rates on some deposit categories continuing to edge down, and with market interest rates flat or even a little higher than last fall and stock prices rising rapidly, savers may be finding non-M2 assets more appealing. In addition, M2 balances may be substituting to an extent for consumer credit in response to tax reform. Businesses have been shifting away from short-term credit, including bank loans, and toward the bond and equity markets, which has acted to hold down bank credit growth and issuance of CDs and other managed liabilities in M3.

Based on this recent behavior, we now think that growth of both M2 and M3 this year consistent with the staff's economic forecast may be a little below the midpoints of the Committee's long-run ranges. Lower money growth is not reflected in the forecast itself, which as Mr. Kichline has indicated, is essentially unchanged from last time, as are the interest and exchange rate assumptions underlying it--that is, for interest rates to remain around current levels before beginning to edge higher later in the forecast period and for the dollar to decline at a moderate pace.

In the bluebook, the staff is projecting a rebound in money growth over the next three months under the reserve conditions of all three alternatives. In part this projection is based on the presumption that many of the influences contributing to recent weakness are temporary, or at least will not be as strong as in recent months. This would be true to the extent they have been associated with the effective date of the tax bill--either the surge in transactions and loans beforehand or the initial adjustment to the change in after tax costs and yields. Under alternative B, M2 and M3 would be expected to grow at about the same pace as income over the months of the second quarter, though--because of their low starting point--

on a quarterly average basis their expansion would fall short of GNP, producing the first increase in the velocities of these aggregates in some time. The 6 percent March to June M2 growth expected under this alternative is about in line with the results of the econometric money demand models, given unchanged interest rates and the greenbook income projection.

Uncertainty about the underlying monetary relationships and the possibility that the new tax law could affect payment and deposit patterns around the upcoming tax date--including flows into IRAs--suggest a fairly wide range of possible outcomes around the staff forecast. Money growth may not snap back to the degree anticipated if some of the factors that have been damping money are not as temporary as supposed or if income falls short of expectations; on the other hand, if the economy conforms roughly to the staff forecast, continued very slow growth and a sharp rebound in velocity would be unusual without a major upturn in interest rates.

Alternative A would be most consistent with concern that money growth around the lower ends of the long-run ranges was indicating the potential for a sluggish economy. Short of alternative A, a tilt toward ease in the directive language concerning intermeeting adjustments might be considered appropriate if further shortfalls in money growth were seen as raising the odds on subpar economic performance, especially if this were reinforced by incoming economic indicators. The clear risk of a substantial downward adjustment of the dollar if interest rates in the U.S. fall might be considered acceptable if underlying demands on the economy were seen as weak--particularly if such weakness stemmed from a failure of the trade balance to show appreciable improvement.

On the other hand, prices already have picked up, and the downward slide of the dollar, especially if it were to continue at close to its

record pace, could well accentuate inflationary pressures. Concern about such factors would be consistent with alternative C, or a tilt in a firming direction in the intermeeting adjustments perhaps keyed to continued pressure on the dollar. Such pressure itself might be seen as suggesting market concerns that nominal returns on dollar assets were not sufficiently high to compensate for the possibility of fairly rapid inflation; the back-up in bond yields and precious metals prices over recent days may suggest that potential interactions between the dollar's external value and inflation are affecting expectations. A tightening of reserve conditions runs the risk of the aggregates running below their ranges. Such a risk might be considered acceptable given that the slow growth in the first quarter seemed to reflect portfolio shifts unrelated to the economic outlook, and that a continued shortfall in money would be occurring in circumstances of higher inflation and, under alternative C, interest rates. Low money growth could be considered appropriate in such an environment, since velocity would be expected to increase, reversing at least some of the declines of the last two years.

Under any of the alternatives, the Committee might want the Desk to pay particularly close attention to the behavior of the dollar and conditions in foreign exchange markets in implementing monetary policy over the coming intermeeting period. They already are taken into account in the conduct of operations, and are prominent in the list of items that should be assessed when considering any change in the basic reserve stance of the System. Additional emphasis could always be made clear in the Committee's discussion and reflected in the policy record. But if the Committee wished to give the dollar and exchange market particular emphasis in framing open market operations, it might want to reflect that in the directive itself.

One possibility would be to bring the foreign exchange market reference in the existing sentence on intermeeting adjustments further forward. Alternatively, the Committee might want to consider entirely new language on the dollar and open market operations. The language in brackets--keyed to instability in the dollar--has been suggested as a starting place for such an approach.